

A Historic and Contemporary View of the  
United States Tax Laws in Relation to the  
Proposal of a Flat Rate Income Tax

An Honors Thesis (ID 499)

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Taxes are loathed by nearly everyone. One tax that has drawn much recent criticism is the federal income tax. The present progressive tax system is considered to have many problems. Among these are bracket creep, marriage penalties, complexity, an underground economy, fairness, and the burden it puts on economic growth. Recently, Washington has been thinking about simplifying the present tax code with a single tax rate and few, or no, deductions. In 1981 it was noted that the most common tax proposal by the American people was the flat rate income tax.<sup>1</sup> Supporting the flat tax are both Democrats and Republicans. Arthur Laffer and others have suggested it as a possibility for rescuing Reaganomics. This idea has been floating around Washington for 20 years, but it is now being seriously considered by more legislators of varied persuasions.

Our present income tax was instituted in 1913. The rates ranged from one percent to seven percent on incomes in excess of \$500,000. It started taxing taxable incomes of more than \$3000, which was considered a high income in those days. Over the years, the top rate has risen to 91 percent. In 1964 it was lowered to 70 percent. The recent tax cuts have left us with a low rate of 11 percent and a top rate of 50 percent. It has generally been felt that taxes should be assessed on the ability to pay; and that as a person's income goes up, so does his ability to pay a greater percentage of his income in taxes. Those who feel this way use the

theory of a declining marginal utility of the dollar. People following this theory say that, after a certain point, each dollar of income is less valuable because it is not spent on necessities; therefore higher income should be taxed at a greater rate. In addition to rate changes over the years, deductions, exemptions, and exclusions were added and deleted. Taxation is becoming so complicated that a person needs special training just to complete a return.

Our income tax should have as its goal a means to raise the revenue needed to run the government. It is now promoting secondary social goals. To encourage people to save for retirement, the Internal Revenue Code allows the deduction of pension expenses. This is estimated to cost \$27.5 billion in lost taxes. While trying to help the housing industry by allowing mortgage interest to be deducted, the government loses \$25.5 billion per year. Other deductions bring the estimated revenue loss for 1983 to \$250 billion.<sup>2</sup> Each of these deductions or exclusions are allowed to promote some social goal. This, together with other federal, state, and local taxes, makes the overall tax burden approximately proportional.

Two problems of progressive taxation that people often complain about are bracket creep and the marriage penalty. As income is increased at the same rate as inflation people are often pushed into a higher tax bracket. As a result, their after-tax income can buy less. The marriage penalty

refers to the difference between the tax tables for married couples and those for single people. Two single people would pay less combined tax on both incomes than what a husband and wife would pay on the same amount. For this reason, some people may choose not to get married, but to live together instead.

Because people with high incomes are often in one of the top tax brackets, they try to shelter their income. Andrew Mellon, Secretary of the Treasury under Harding and Coolidge, felt that high rates caused the people to withdraw their capital from productive businesses and invest it in tax-exempt securities or other tax preference income sources. Then sources of taxation dwindle, wealth fails to carry its share of the tax burden, and capital is diverted into channels which yield neither revenues to the government nor profit to the people. This is still the case today. It has been calculated that rerouting of capital has caused the gross national product to be much less than it could otherwise be. People are still looking for the highest after-tax profit, which is only to be expected.

Along the same lines, businesses tend to lose their inventiveness, innovation, risk-taking, and originality because the present tax laws discourage these. Concerning new businesses trying to make a beginning, Ludwig von Mises said,

The old firms do not need to fear his competition; they are sheltered by the tax collector. They may with impunity indulge in routine, they may defy the

wishes of the public and become conservative. In this sense progressive taxation checks economic progress and makes for rigidity.<sup>3</sup>

The Internal Revenue Service has another huge problem--noncompliance. They estimate this costs \$95 billion annually. This is over one-quarter of the annual income tax collected. This income is all legally earned and it should be taxed, but it is never reported.<sup>4</sup> More members of Congress are beginning to feel that if they make the income tax simpler and fairer there will be greater voluntary compliance.

It is estimated in most studies that a progressive income tax decreases work effort. In a recent study by the Massachusetts Institute of Technology, it was found that the desired number of work hours would go up by five to ten percent if a flat rate tax were instituted.<sup>5</sup> Other studies have shown that taxes also influence people's decisions about their careers. The decision to take early retirement is affected by a person's tax bracket. The quality of one's work and the choice of how much education to get are also affected by tax rates. Some people feel that an opposite force, the income effect, makes people work harder as they are pushed into a higher tax bracket in order to maintain the same after-tax income.

The combination of all these problems result in a tax system that is not performing as it should. It has become a haven for special interest groups and their social goals. It is hurting the productivity of our people and our businesses.

Due to deductions and capital gains provisions, the wealthy are often not paying their fair share, such as billionaire Bunker Hunt who, between 1975 and 1977, paid less than \$9.65 in taxes.<sup>6</sup> Congress has several proposals to revamp the tax system with something that would curb all these problems. Perhaps a flat rate income tax would do this.

Presently the tax base is narrow and the rates are high. Those who favor a flat rate tax would broaden the tax base and make a drastic cut in rates. A flat rate tax should take away all deductions, exclusions, and credits. It could still permit an allowance for dependents. This describes a basic flat rate tax.

Other tax bases that could be used would be taxable income and adjusted gross income. Using taxable income as a base, income would be figured as it is presently figured. The taxable income would then be multiplied by a flat rate of around 19.5 percent.<sup>7</sup> This would maintain the complexity since the confusing part of figuring taxes is deciding the exemptions and deductions to which you are entitled. This income base would do nothing to improve the economy. The capital gain exclusion would still be available. People would still invest in what they felt would provide the greatest after-tax profit, which is often different from that which would provide the greatest economic gain.

Using the adjusted gross income as we now know it for a tax base would allow a lower rate of around 15.5 percent.<sup>8</sup>

Adjusted gross income is before the subtractions for excess itemized deductions and personal exemptions. It would still exclude some income such as unemployment compensation, 60 percent of capital gains, and contributions to individual retirement accounts. This method would also maintain much of the complexity of our present system.

Some people also consider a modified graduated rate tax or an integrated flat rate tax to be viable alternatives. Under a modified graduated rate tax most itemized deductions are retained. The progressive rate structure is also retained, but with fewer levels. This is not a flat rate tax, but one that is progressive. It would do nothing to help simplify the present system or to help the economy.

The integrated flat rate tax uses the assumption that all income need only be taxed once, and that should be close to the source of the income. Dividends would not be taxed because they would be taxed at the corporate level. Capital gains would not be taxed. All of our present deductions would be disallowed, but the personal exemption would be retained.

Our lawmakers have also been busy thinking of ways to tax our incomes at a flat rate, or at least a flatter rate. In Congress there are four proposals that are truly pure flat rate tax plans. Senator Helms' (R-North Carolina) proposal would rid the system of every tax preference except for a \$2000 personal exemption and tax everyone at 12 percent.

Representative Crane (R-Illinois) would also increase the personal exemption to \$2000 and repeal all other deductions, exemptions, exclusions, and credits. As opposed to Helms, Crane would make the tax a mere ten percent. Representative Dreier (R-California) would do exactly as Crane, except he would make the tax 14 percent. Representative Paul (R-Texas) would provide the ten percent tax rate and do away with all tax preferences except the personal exemption, which he would raise to \$10,000.

Representatives Hansen (R-Idaho) and Panetta (D-California) each have bills that would retain some exclusions and deductions. Panetta would only allow deductions for the production of income and alimony or support payments. He would establish tax credits in the place of our present personal exemption. Income would be taxed at 19 percent under this plan. Hansen would still allow deductions for expenses for the production of income, church contributions, medical expenses, alimony, and separate maintenance payments. His plan would set a tax rate of 14 percent.

Senators DeConcini (R-Arizona) and Quayle (R-Indiana) believe that dividends, interest, and capital gains should be taxed to the business taxpayer instead of the individual taxpayer. DeConcini would tax labor compensation at 19 percent. He would still allow a personal exemption. Senator Quayle believes that wealthier taxpayers should pay a higher rate than other taxpayers. He would tax incomes between



\$17,500 and \$50,000 at 18 percent and incomes above \$50,000 at 25 percent. This income would also exclude dividends, interest, and capital gains. There would still be a personal exemption, but only \$600. This plan would do away with the marriage penalty because each person would be taxed individually.

Senator Bradley (D-New Jersey) and Representative Gephardt (D-Missouri) would broaden the tax base by repealing many deductions and exclusions, such as casualty losses and capital gain income. Their bill would also do away with some tax credits. It would retain deductions for home mortgage interest, contributions, and income and property taxes. It would increase the personal exemption and make unemployment benefits fully taxable. Income would still be taxed at progressive rates ranging from 14 to 28 percent. They feel most people would pay less in taxes. Those who heavily itemize deductions and have capital gain income would be hurt. This could harm investment because there would be no capital gain deduction, yet people would still be taxed at progressive rates. If people are not given a deduction for capital gains or a low tax rate their desire to invest will diminish.

It has been noted that the revenues collected in 1978 could have been produced with a flat rate tax of 11 percent if this were applied to what the National Income Accounts consider to be personal income.<sup>9</sup> Former Treasury Secretary William E. Simon found that a 16 percent flat rate tax would

be needed on both personal and corporate income to balance the 1983 budget. It has also been noted that a 19 percent flat rate tax on income over \$6000 would balance the 1983 budget.<sup>10</sup> The present level of revenue could be raised by doing away with most deductions and imposing a 16 percent flat rate tax. This plan would also allow a family of four a \$5000 exemption.<sup>11</sup>

Eliminating all tax preferences and making everyone pay the same rate would be the ideal flat rate tax. Taxing all income, regardless of its source, would end the complaints of those who feel that the rich are able to shelter much of their income through the use of tax preferences. Some consider a flat rate tax system to be inequitable because it does not consider a taxpayer's expenditures, hardships, or family size. If a personal exemption were allowed, it would help in this area, yet it could still be considered a flat rate tax. Most opponents of the flat rate tax point out that it would cause higher taxes for those making less than approximately \$30,000 a year, and less taxes for those who earn more than this. They also have observed that those who pay less than the effective rate for their income group could see substantial increases in their taxes. If social security retirement benefits were taxed, people in the \$15,000 to \$20,000 income group would be hurt most. Not allowing state and local taxes to be deducted would hurt all income classes evenly. If employer contributions to medical plans were taxed

it would affect those making \$30,000 to \$50,000. Disallowing the deductibility of home mortgage interest would most affect those incomes between \$30,000 and \$100,000. If pensions could not be deducted, it would hurt those making \$50,000 to \$100,000. If the capital gain exclusion were taken away, those making over \$100,000 would notice it the most on their tax bill.<sup>12</sup> This seems to point out that those making over \$30,000 per year would pay more taxes, not less.

Bracket creep and the marriage penalty would both be eliminated if a flat rate tax system were enacted since everyone would be taxed at the same rate. Simplification of the tax code would also result. Complex decisions regarding the tax effect would not need to be made before investing. This would result in fewer people using the services of accountants and lawyers, who prepare tax returns and give tax advice.

By instituting a flat rate tax it is possible that tax revenue would increase. Hundreds of billions of dollars of income are presently exempt. Taxing this would raise tax revenue. The trade-offs between work and leisure and investment and consumption are now leaning toward leisure and consumption because the high and progressive tax rates give people little incentive to invest or to work any more than they need to in order to get by. By instituting a flat rate tax people would work and invest more because they would not feel as if they were being punished for doing so. More work

and investment would increase the tax base and thus the tax revenues. The incentive to cheat on taxes would also be reduced by a substantial tax rate reduction. In countries with marginal tax rates that are much higher than ours, cheating proliferates.<sup>13</sup>

A flat rate tax would have many positive effects on the economy. People would start investing based on the real value of the investment. This would promote a more efficient allocation of resources. Some feel that a flat rate tax could provide the revenue to balance the 1983 budget and provide more economic incentives than the present tax code provides. Some feel that getting rid of present benefits could hurt the economy. They feel the mortgage deduction is what keeps people buying homes and without it real estate value would drop drastically. This would leave the housing industry in worse shape than it is presently. Taking away the 60 percent long-term capital gains exclusion could affect the ability of corporations to issue stock. In reality, people would probably make their investment decisions differently and choose those which would yield the highest profit. This would help the economy as a whole. If the investment tax credit is removed, the effective cost of acquiring equipment goes up. As a result, outdated, unsafe equipment may be kept rather than replaced causing a negative effect on the economy. On the other hand, more money may be available to spend on equipment if taxes were lowered.

Presently there is an alternative minimum tax. This is to assure that people pay at least a very small tax on their tax preferences. This tax could be eliminated under a flat rate system because there would be no preference items to allow people to get out of paying taxes.

Studies have shown that the price effect is stronger than the income effect, that is, when it costs more to give, people give less.<sup>14</sup> This scares people into believing that charities would suffer greatly if people could not deduct their contributions. This thinking does not take into account the increase in disposable income that would result for most people under a flat rate system. If people had more disposable income they may be inclined to give more. Hopefully, Americans would keep giving even if there is no tax advantage in doing so.

By eliminating some deductions, private alternatives would be discouraged in favor of government programs. A flat rate tax may discourage private retirement plans, private welfare, and any other private means of accomplishing social objectives.<sup>15</sup> This could take away some of the government's competitors and result in a monopoly by the Federal Government. History has shown that government monopolies can do as much harm as private monopolies. A monopoly would cause the quality of services to fall. The government monopoly would also cause prices to rise.

Instituting a flat rate tax would cause a major redistribution of the tax burden, but there are other problems that are more serious than this. Any change as drastic as this would cause many existing investments to be uneconomical. It would hurt present investments because it would take away deductions that the investors were counting on. There would need to be special phase-in rules to protect these taxpayers. Some have estimated that this transition period would take ten to 15 years. This would mean two tax systems would exist at the same time for a while.

Milton Friedman has observed that a constitutional amendment would be needed to insure that the tax would stay flat. The big problem is that the rate could be increased whenever Congress feels like spending more. This could be solved by setting a fixed flat rate. Therefore, when gross national product and income increase, so would government income. On the other hand, when consumer income decreases, so would government revenue. It could be a way to keep a lid on the spending that Congress so easily finds itself doing.

The present system of taxation certainly needs an overhaul. A flat rate system could relieve it of its many problems. A flat rate system would do away with the inequities of progressive taxation. All people would pay their fair share without anyone being unreasonably burdened. A flat rate tax would increase investment, boosting the economy. A flat

rate tax is certainly the best idea for taxing income that we have before us at this time.

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